The Behavioral Law & Economics of Regulation

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I. Regulatory objectives

A. Regulate in accordance with statutory mandates

B. Mitigate serious risks at reasonable cost

1. Requires determining which risks are serious

2. Requires gauging what sorts of expenditures are reasonable in light of existing risks

II. Behavioral pathologies related to risk regulation

A. Salience/availability bias

1. Tendency to overstate risks that are more salient, more easily "available" to the mind

a) E.g., sensational national news stories that capture wide attention

b) Three Mile Island, ozone layer hole, newsworthy public events, deaths, etc.

c) Contrast with climate change, other slow-moving effects

2. Tendency to overstate risks that seem especially terrifying, horrific, inhuman

a) Nuclear power, plagues and pathogens, etc.

3. Contrast with everyday workplace accidents, traffic accidents

B. Hyperbolic discounting

1. Tendency to weight immediate costs and benefits much more heavily than future costs and benefits

2. Affects individuals in their daily lives even more strongly (retirement savings, cigarettes, etc.)

3. Some discounting is appropriate; too much discounting can lead to regulatory paralysis

    a) Federal regulators: 3% or 7%

4. Costs are often immediate; benefits are often latent

C. Representativeness bias

1. Belief that a single example is representative of a larger group

2. E.g., I've seen one type of accident or injury—I now know what the majority of them will look like

    a) Or: I understand the operation of one firm in this industry, so I now can anticipate the operation of other firms

3. Interacts with salience bias to distort decision-making

    a) The most salient example often comes to stand in for the entire class

III. Ways of combatting behavioral biases

A. De-biasing

1. Become aware of behavioral biases, actively work to counter them psychologically

2. Better than nothing, but often not highly successful

3. Problem: optimism bias. We think we are better at overcoming biases than we actually are

B. Group decision-making

1. Analyze and discuss regulatory decisions as multi-member bodies

    a) With outside input, such as via the adversarial process

2. Problem: motivated reasoning

a) With multiple sources of information available, will tend to select the information most amenable to the favored point of view

3. Second problem: groups tend to go to extremes

a) Social dynamics can lead group deliberations to reach extreme outcomes

C. Best option: use cost-benefit analysis or a similar quantitative decision procedure

1. Generally not mandated by state law (not in Illinois)

2. But good practice generally

a) Imposes discipline and constraint on thinking

b) Counter-acts behavioral biases that can lead regulatory decision-making astray

3. Gathering and quantifying costs and benefits can be challenging

a) But uncertainty need not be a barrier

b) Regulators can always make best guesses, as they are currently doing

IV. Conclusion and suggestions for further reading